Senator Jeff Merkley & Senator Carl Levin

PROP Trading Amendment: Keeping High-Risk Trading From Bringing Down Our Financial System—Again

High-risk proprietary trades directly contributed to the financial crisis as "too big to fail" financial institutions gambled heavily – and lost. To save our entire financial system from collapse, the government was forced to establish the TARP to bail out those bad bets. To protect against the financial crises caused by huge private bets gone bad, Senators Jeff Merkley and Carl Levin have introduced an amendment based on the Protect our Recovery through Oversight of Proprietary (PROP) Trading Act, which will:

Restrict Proprietary Trading by Banks and Large Non-Banks

- Bar depository banks and their affiliates and subsidiaries from engaging in proprietary trading.

- Bar depository banks and their affiliates and subsidiaries from investing in or sponsoring a hedge fund or private equity fund.

- Require large critical nonbank financial institutions to be subject to strict capital charges and quantitative limits to rein in their proprietary trading and investing in or sponsoring a hedge fund or private equity fund.

- Direct the Board of Governors and the FDIC, in consultation with the SEC and CFTC, to issue rules to implement the prohibitions or restrictions.

- Direct the appropriate regulators to issue rules that rein in high-risk trading in covered firms, while allowing for traditional client-oriented services, such as:
  - Purchasing and selling government obligations,
  - Underwriting and market-making to serve clients,
  - Risk-mitigating hedging activities,
  - Insurance investment activities within state-regulated insurance companies,
  - SBA small business investment company investments, and
  - Other activities that do not result in material conflicts of interest, holdings of high-risk assets or high-risk trading strategies, threats to safety and soundness, or pose a threat to U.S. financial stability.

- Permit banks and bank holding companies to continue to provide advisory services to hedge funds as long as they maintain arms-length transactions and do not create a taxpayer bailout risk through their relationship.

Prohibit Conflicts of Interest by Underwriters

- Prohibit any underwriter of an asset-backed security from engaging in transactions that create material conflicts of interest with respect to the securities being sold, and direct the SEC to issue rules implementing this conflict of interest prohibition.

Frequently Asked Questions

What is proprietary trading?

Proprietary trading is where a financial institution deploys its own capital as an investor. Over the past dozen years, it has become an increasingly large portion of the business conducted by the nation's largest financial institutions. For example, at the end of 2009, the large banks reported to the FDIC that their trading revenues (as opposed to revenues from lending and other traditional banking activities) accounted for 77% of their net operating revenues.

Lehman Brothers is a great example. In 1998, it had $28 billion in proprietary holdings. By 2006, proprietary trading revenues accounted for 58% of the firm's total revenues. And by 2007, its proprietary holdings topped off at $313 billion. When the values of these holdings declined in 2007 and 2008, Lehman Brothers lost $32 billion, nearly double the $18 billion in common equity the firm had in late 2006. By September, the firm had collapsed into the largest bankruptcy in history.

Why is proprietary trading dangerous?

Proprietary trading brings high amounts of risk directly into the financial infrastructure and has caused problems for our financial system repeatedly. It was a large part of the banking collapse in 1929 (which is why Glass-Steagall was initially enacted). In 1998, as Glass-Steagall restrictions were being weakened, prop trading in complex derivatives left the major Wall Street banks facing billions in losses. The Federal Reserve organized the first massive bailout of a "too big to fail" non-bank, Long-Term Capital Management (much the way the bailout of AIG prevented even further losses). And now we have had round III, when proprietary trading in subprime securities and derivatives was the *critical factor in the failure of major Wall Street firms in 2008*. By April 2008 alone, the nation's largest financial firms had suffered $230 billion in losses based on their proprietary trading – even before the markets froze further later in the year. By the end of 2008, the taxpayers were forced to swallow the costs of those bad bets, putting up hundreds of billions of dollars in TARP funds originally intended to buy back those prop bets.

Now, the only question is whether we will stop this system wherein banks and non-banks can place one sided bets: heads they win, and tails the taxpayers lose.